

Hi Ho, Retro

# The Prepayment-Protection Loan Rides Again

by James J. Cotton and Susan F. Mudry

GIVEN ENOUGH TIME AND THE right conditions, anything old can become new again. Think lava lamps, mini skirts, neon colors and the prepayment-protection mortgage. That's right, not even the mortgage market is immune to flashbacks. The prepayment-protection mortgage (PPM), which faded in the 1980s, is back.

Changing market trends and a shifting economic environment have set the stage for the re-emergence of the PPM. The question now is whether the PPM is but a passing fad like so many other products popular in the 1970s or whether it is a viable loan choice for some borrowers that is here to stay.

## A Rate Break for a Promise

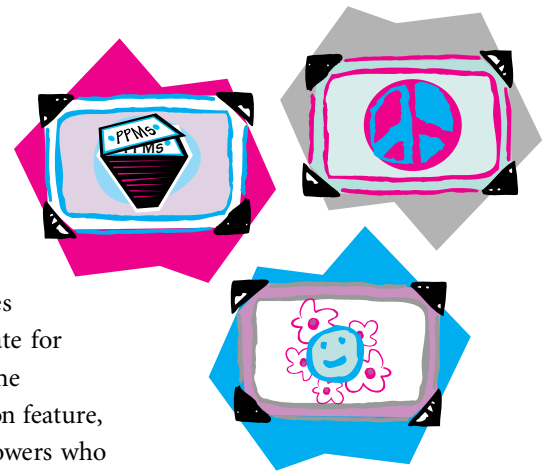
A PPM differs from other mortgage instruments in two important respects. First, the PPM borrower gives up the right to prepay the loan without penalty in its early years. Second, the borrower gets a lower interest rate over the life of the loan. As a result, PPMs address an issue of basic fairness among

borrowers. Lenders cannot determine at origination which borrowers are most likely to prepay, so they charge *all* borrowers higher rates and fees to compensate for prepayment losses. The prepayment-protection feature, however, allows borrowers who do not expect to prepay to take advantage of a lower interest rate.

Taking out a PPM does not prohibit a borrower from refinancing during the prepayment moratorium period, but the action does trigger a consequence. Usually, a borrower must repay some of the savings stemming from the lower interest rate, which often can amount to a few thousand dollars.

In return, the lower interest rate charged for PPMs hands borrowers an affordability tool to reduce the cost of purchasing a home. Compared to the interest rate on a standard 30-year, fixed-rate mortgage, the rate on a PPM is lower by up to one-quarter of a percentage point.

A rate break of that order can make a major difference to would-be borrowers struggling to purchase a first home. An estimated 167,000 more renter households could qualify to buy



a home at that lower rate, based on calculations that draw from the empirical studies of homeownership rate swings conducted by Peter Fronczek and Howard Savage of the Census Bureau.

## Form Follows Function

PPMs are intended to discourage borrowers from refinancing if market interest rates fall during the first three to five years of the loan. (The sale of a home also triggers the prepayment-protection clause under some PPM mortgage policies, although such a provision is much rarer than in the past.)

Mortgage servicers and investors alike are eager to keep borrowers from paying off their mortgages earlier than anticipated but for different reasons.

The servicer administers the loan, collecting and disbursing

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the monthly mortgage payments. A servicer gets hurt when a mortgage prepays because the company has paid up front for the right to handle the loan and to receive a portion of borrowers' monthly payments for doing so. That income flow ends abruptly when borrowers prepay.

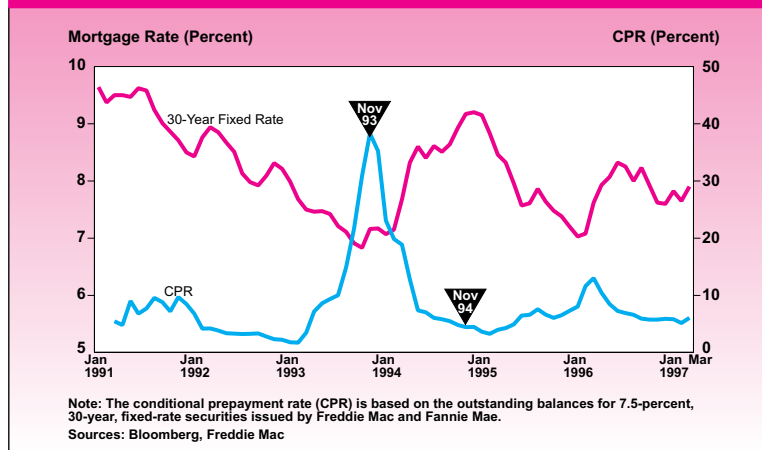
A servicer, of course, will find new loans to replace the lost business. Nonetheless, **portfolio runoff**, as the phenomenon is known, tends to produce a net loss; mortgages typically do not prove profitable for several years.

Investors supplying the capital to fund mortgages are eager to keep borrowers from paying off their loans when interest rates fall. When confronted with the simultaneous return of hundreds of above-market-rate mortgages, investors can run into difficulty finding an alternative investment vehicle that pays an equivalent return.

Investors last struggled with reinvestment risk during the 1992–1993 refinancing boom. That's when interest rates plummeted by roughly 2 percentage points to 7 percent, prompting borrowers to retire one in every three existing mortgages.

One way of seeing the impact that declining interest rates can have on investors is through the **conditional prepayment rate (CPR)**, a monthly indicator that tracks the annualized pace at which the loans in a mortgage-backed security are repaying.

**EXHIBIT 1: Mortgage Interest Rates and Securities Prepayment Speeds**



**When mortgage rates tumbled 2 percentage points during the 1992–1993 refinancing boom, the speed of premature loan repayments quickened dramatically. In November 1993, prepayments occurred so rapidly that, had the same pace continued through November 1994, an average mortgage pool's value would have dropped 40 percent.**

*Exhibit 1* shows that as mortgage rates fall, the prepayment rate climbs dramatically, exposing investors to increasing reinvestment peril.

#### **Making Everyone Happy**

By offering a lower interest rate on PPMs, investors are attempting to “pay” borrowers to assume some of the risk of interest-rate fluctuations. By giving borrowers a below-market interest rate at origination and imposing a fee for refinancing, a PPM effectively reduces the probability that interest rates will ever drop enough to make refinancing desirable (see “Truth and Consequences, PPM Style,” page 15).

The long-run success of this product, then, depends on

whether investors will pay borrowers enough to gamble that interest rates will not fall below the rate on their PPMs.

Many investors are better positioned to understand and endure swings in interest rates, making it cheaper for them to carry that risk. Consequently, PPMs are unlikely to surpass the popularity of the standard-mortgage contract. However, PPMs could develop into an important niche product among investors who are extremely sensitive to prepayment risk and borrowers who consider a lower rate sufficient compensation for the loss of some flexibility in their refinancing choices.

### Deja Vu All Over Again?

Today's standard-mortgage contract grants borrowers a **call option**, the unfettered right to prepay the debt at any time without notice or penalty. In the 1940s, however, most mortgages carried a prepayment-protection clause tied to a moratorium that extended over the life of the mortgage. Moreover, the clause was triggered by any prepayment circumstances, including the sale of the home. Thrifts and banks insisted on the stricter conditions because they needed the prepayment-fee income to help balance the cost of their deposit liabilities and mortgage assets.

PPMs began to fade in the 1970s as rising interest rates made refinancing an unattractive proposition. By the early 1980s, PPM usage had fallen sharply. At the start of that decade, approximately 16 percent of all mortgaged properties were subject to a prepayment fee. By the time the 1980s drew to a close, PPM market share had dropped to 8.7 percent, according to the Department of Commerce.

One explanation for the declining popularity of PPMs rests with the growing importance of the secondary mortgage market during that period. As thrifts and banks increasingly ceded their mortgage-funding role to companies like Freddie Mac, lending practices shifted to meet the needs of the new funding sources. The secondary market

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companies preferred nationally standardized loan contracts that excluded prepayment-protection provisions as a simple way of dealing with a variety of state laws that restricted PPM lending in some way. Even now, state laws vary, with some permitting lenders to charge buyout fees of up to six months' interest, others limiting borrower assessments to no more than 1 percent of the loan amount and a number prohibiting the product altogether.

Plunging interest rates in the 1990s have refocused investor attention on borrower prepayment behavior. Borrowers, who had contrived to hang on to what were then low-interest-rate loans in the 1980s, began clamoring in the early 1990s to get rid of what had become high-interest-rate mortgages. What's

more, certain developments in recent years—namely **no-closing-cost mortgages** and sophisticated customer-prospecting techniques that allow lenders to pan for the best refinancing candidates—have encouraged the urge to refinance.

Not surprisingly, then, investor interest in prepayment protection again began to grow. In response, Freddie Mac worked with the lending community to develop PPM securities products, which the company is extending on a lender-by-lender basis. In early 1997, the company began funding PPMs, but only those that do not subject borrowers to buyout fees when the sale of the home creates the prepayment; the fee applies only when borrowers refinance during the first three or five years after loan origination. The loan servicer retains any buyout-fee income collected, due to the administrative difficulties associated with passing the income through to the end investor.

Freddie Mac has dedicated two mortgage-security **prefixes** to fixed-rate PPM products. The designations provide investors with the means to price and track their PPM-backed security holdings with greater precision. The company also added adjustable-rate PPMs to its line-up a few months later. However, those loans go into generic security pools where they are not flagged as PPMs but simply mixed together with other adjustable-rate loan products.

Freddie Mac's PPM prefixes correspond to the two most popular PPM structures. One version limits the moratorium to three years and pegs the buyout fee to 2 percent of the remaining loan balance. The other arrangement consists of a five-year moratorium with a buyout fee equal to six months' interest on the remaining balance. Countrywide Home Funding is among those lenders offering the five-year plan (see "One Lender's PPM Story," page 16).

### Maybe Yes, Maybe No

How PPMs will fare in the future remains an open question.

One unknown is whether investors will place enough value on prepayment protection to sufficiently compensate borrowers for increased risk exposure. The relative illiquidity of PPM securities currently is hindering investors' willingness to lower their yield expectations enough to attract borrowers. Also working against the PPM are stable or rising interest rates, which deprive the instrument of its main investor benefit—the ability to slow prepayment speeds.

Investors also worry that lenders might waive the prepayment fee to dissuade borrowers from refinancing with competitors. In that event, borrowers receive another incentive to prepay early, the very behavior that investors are trying to change through PPMs.

## Truth and Consequences, PPM Style

Although PPM and standard-mortgage borrowers may go through a similar thought process when considering whether to refinance, they may well arrive at different answers.

Comparing the monthly savings from swapping into a lower interest rate to the cost of the transaction is one way to decide if refinancing makes sense. Borrowers then can determine how long it will take to recoup their refinancing costs.

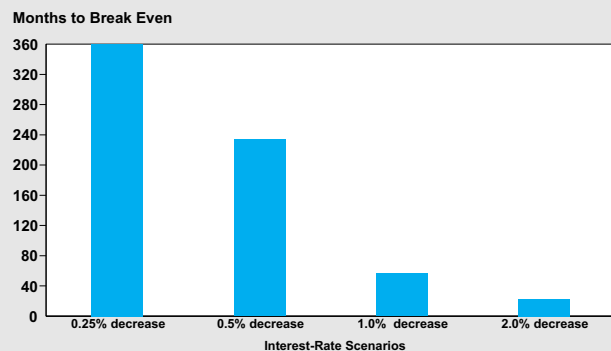
Assuming neither mortgage type involves out-of-pocket closing costs, standard-loan borrowers stand to benefit from refinancing given *any* drop in interest rates. PPM borrowers, however, must take into account the buyout fee they incur for refinancing during the agreed upon moratorium.

Consider two borrowers who take out 30-year, fixed-rate mortgages for \$100,000. One borrower chooses a standard-mortgage contract bearing an 8-percent rate. The other opts for a PPM with a discounted rate of 7.75 percent. The PPM borrower obtains the lower interest rate by agreeing to a typical PPM structure, which requires a buyout payment equal to six months' interest on the outstanding balance exceeding 20 percent when prepayment occurs during the first five years of the loan.

Two years into the mortgage, the PPM borrower has paid down the loan balance to \$98,000. Breaking the prepayment moratorium would cost about \$3,000  $[(\$98,000 - \$20,000) \times (7.75\%/2)]$ . Whether the PPM borrower could save enough from refinancing to offset the \$3,000 depends on the magnitude of the interest-rate drop.

A one-quarter-percent decline from 8 percent would provide no value to the PPM borrower, who already captured a lower 7.75-percent rate when the loan was originated. As the chart below illustrates, the prepayment assessment is never recovered over the life of the loan, making it highly unlikely that the PPM borrower will refinance.

If interest rates drop by one-half of a percentage point to 7.25, then it would take the PPM borrower almost 20 years (235 months) in **present-value** terms to recoup the buyout fee. If rates fall by 1 percentage point, it still would take almost six years (55 months) to reach the break-even point. Given that the prepayment moratorium would expire in just three years, the borrower probably would not refinance in either case.



Note: Break-even scenarios are calculated in present-value terms.  
Source: Freddie Mac

Only with a 2-percentage-point drop in rates would the PPM borrower find it cost-effective to refinance because it would take less than two years for the monthly savings to outweigh the buyout fee.

The PPM structure does not prevent borrowers from refinancing. However, given the length of time it would take PPM borrowers to recoup refinancing costs under any interest-rate scenario, they possess less incentive to refinance than standard-loan borrowers, who can recoup refinancing costs almost immediately.

—Susan F. Mudry, financial analyst

### A Return to Fashionability

Despite the uncertainties, PPMs appear poised to make greater inroads to market acceptability. The general public only now is becoming aware of PPMs, so more extensive mainstream and industry media coverage likely will increase familiarity and demand for the product. Also, growing standardization within the product line will make it easier for borrowers to first understand PPMs and then ask for them.

Like retro fashions and other 1970s accoutrements, PPMs are staging their comeback at the right time. Enough consumer and investor interest exists to give the product a shot at a small but permanent place in the mortgage marketplace. In the long run, greater investor demand may enable PPMs to go from making a fleeting fashion statement to becoming a permanent part of investors' financial statements. **SMM**

## One Lender's PPM Story

In May 1996, Countrywide Home Funding Corp., the nation's largest independent mortgage banker, introduced the Reduced Rate Option, a prepayment product for conforming, 30-year, fixed-rate loans.

This option, available to borrowers purchasing a home or refinancing an existing loan, shaves off as much as one-quarter of a percent from the mortgage-interest rate, producing significant savings over the life of a loan. For example, a rate reduction to 8 percent from 8.25 percent on a \$100,000 loan would lower a borrower's monthly mortgage payment from \$751 to \$734. The homeowner would save \$204 annually, or about \$2,600 over a 30-year loan term.

A homeowner may sell the property or pay down the loan by as much as 20 percent during the first five years without incurring a prepayment charge. However, in the face of a refinance or larger principal reduction, the borrower becomes liable for a prepayment fee equal to six months' interest on the outstanding balance left after exempting the first 20 percent of principal.

Countrywide's Reduced Rate Option currently is available in 31 states. They include: Arizona, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Kentucky, Louisiana, Maine, Montana, North Carolina, Nebraska, New Hampshire, Nevada, North Dakota, Oklahoma, Oregon, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Utah, Washington and Wyoming.

